Congress of the United States
Washington, DC 20515

August 5, 2005

Mr. Gordon van Welie, President and CEO
ISO New England Inc.
One Sullivan Road
Holyoke, Massachusetts 01040-4000

Dear Mr. van Welie:

We are writing in the hope of receiving more specific answers to our concerns than ISO New England has thus far been willing to provide. We bring to your attention the enclosed report from Standard & Poor's which echoes a number of the issues that have been raised by New England's Congressional delegation, Governors, Attorneys General, Public Utility Commissions and consumer advocates.

In your July 25, 2005 letter to the New England Governors, you dismiss the concern that there is no guarantee that capacity will be built, by explaining that is "true of all competitive markets." While LICAP is, to quote the S&P analysis, designed "to **mimic** the operation of competitive markets" it is not, in fact a true competitive market as ISO-NE proposes to establish the minimum capacity prices "through administrative fiat, with an eye towards reliability and with little regard to the costs involved."

It is insufficient to imply that the competition envisioned for the system is the pure creation of a free market. The design of LICAP involved countless choices made by ISO-NE, and therefore we would appreciate an explanation of how, exactly, ISO-NE's design for LICAP will address the following deficiencies, as noted in the S&P analysis:

1. Because the LICAP proposal would allocate the capacity payments to all generators, "existing generators will receive increased capacity payments for providing no incremental value or service. To make matters worse, it is not clear why generators would ever want to build enough capacity in any region to receive anything less than the maximum potential capacity revenues."

2. "ISO-NE's methodology will attempt to balance capacity revenues with energy revenues, avoiding duplicate payments. However, this aspect of the LICAP market design may act as a disincentive for merchant generators to build new capacity, in part negating the ISO-NE's efforts."

3. ISO-NE's market design for LICAP sets a minimum reserve margin "that reflects margins used in the days before the industry restructuring, as opposed to the industry standard" which will force "market participants to pay for capacity in excess of their needs ... without providing necessary tangible benefits."

4. "LICAP does not address various barriers to entry that prevent the development of new capacity in areas that need it the most." We believe this is an especially acute problem in Southwestern Connecticut where barriers include high population density, high property cost, and poor air quality. "As a result, it is possible that new capacity will continue to be built away from load, in places where development is relatively easy."

Mr. van Welie, these structural weaknesses of the LICAP proposal must be addressed. It is time for ISO-NE to acknowledge that this market design -- in which generators will receive maximum potential capacity revenues without having to build capacity -- is fatally flawed and should be withdrawn and reworked.

Sincerely,

Christopher Dodd
U.S. Senator

Joseph Lieberman
U.S. Senator

Christopher Shays
Member of Congress

Rob Simmons
Member of Congress

Nancy Johnson
Member of Congress

Rosa DeLauro
Member of Congress

John Larson
Member of Congress

Cc: Hon. Joseph Kelliher, Chairman, FERC

STANDARD &POOR'S

CLO

Print

Despite Potential Benefits, LICAP Causes Considerable Unrest In New England Power Markets

Primary Credit Analyst(s):
Dimitri Nikas, New York (1) 212-438-7807;
dimitri_nikas@standardandpoors.com

Publication date: 25-Jul-05, 11:58:56 EST
Reprinted from RatingsDirect

Quick Links

The Independent System Operator–New England (ISO-NE) has designed a capacity pricing scheme that attempts to address the compensation of merchant power generators to ensure sufficient generation supplies for a reliable and fully functioning wholesale power market. The system, known as Locational Installed Capacity (LICAP), and which is the next step in the restructuring of energy markets in New England, has raised considerable concern among many market participants in the ISO-NE.

While the implementation of LICAP has the potential to provide benefits, there are clearly challenges that must be overcome before the system is widely accepted and provides the benefits it promises. As the FERC is preparing to review the LICAP filing in anticipation of a September 2005 approval, the electric utilities as well as the states' regulators and authorities are expected to continue to push for their voices to be heard. As a matter of fact, state regulators are preparing to discuss elimination of LICAP at their National Association of Regulatory Commissioners' summer meeting in late July 2005. While the effect on the region's utilities is expected to be largely credit neutral, they will have to do considerable work to avoid any public backlash from the increased capacity payments. Nevertheless, the substantial increase in costs can have far-reaching repercussions, as consumers, who will eventually pay for the experiment, may express the largest dissatisfaction. The merchant generators, on the other hand, stand to make windfall profits, even if they adhere to the status quo and do little more than continue to do what they are currently doing.

What Is LICAP?

LICAP is the successor system for Installed Capacity (ICAP), a capacity pricing system first implemented in 1999 in the ISO-NE. Before ICAP, the ISO-NE relied on bilateral capacity markets. These capacity pricing schemes are intended to provide existing generators with capacity payments that allow them to recover some of their fixed costs with a necessary risk adjusted return, while at the same time providing new entrants an incentive to build new generation. LICAP is the latest such design in the evolution of the energy markets that, unlike ICAP that applied uniform capacity prices throughout the New England region, attempts to address specific locational capacity imbalances. In addition, LICAP attempts to replace the Reliability-Must-Run (RMR) contracts that many of the older plants have entered into, and which were intended to provide a desired level of capacity availability and, therefore, reliability, even if they were rarely expected to actually operate.

Over the past year, ISO-NE has pursued the development of LICAP as a

response to a FERC order related to RMR contracts and, on June 15, 2005, a FERC administrative law judge approved the current version of LICAP. The FERC is to render a final decision on the scheme by September 2005 and may accept it or modify it. Full implementation of LICAP is to start in January 2006, with prices established monthly.

↑back to top

What Problems Does LICAP Address?

The motivation for LICAP lies in the fact that while New England as a whole is experiencing sufficient capacity levels, there are pockets in the region that are capacity constrained, especially in the Northeast Massachusetts (NEMA)/Boston and Southwest Connecticut (SWCT) regions, creating potential reliability issues for the market as a whole. Furthermore, a number of old and inefficient plants have entered into RMR agreements, to ensure that they are not retired because doing so could threaten the overall grid's reliability.

LICAP aims to do for the capacity markets what Locational Marginal Pricing has accomplished for the energy markets. By pricing capacity based on regions defined by the ISO-NE, areas with lower available capacity relative to a benchmark reserve margin established by the ISO-NE would have higher LICAP payments, when compared with areas with ample capacity.

Unlike ICAP, which tended to generate either the maximum allowed capacity price or a negligible capacity price, LICAP employs a formula that computes capacity prices based on the level of available capacity compared with the total expected demand plus a reserve margin. This formula leads to a downward-sloping demand curve designed to make capacity pricing more predictable and to mimic the operation of competitive markets. Therefore, as capacity in a region increases, capacity prices begin to drop and vice versa, as capacity in a region declines relative to the benchmark reserve margin, capacity prices rise to provide generators with the incentive to build new plants.

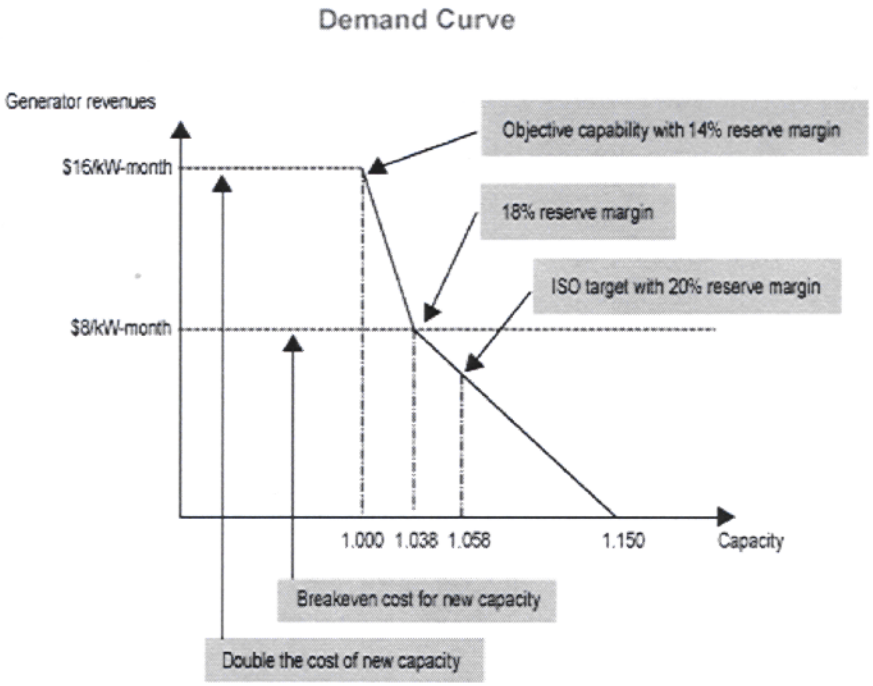
In a departure from the ICAP market and in an effort to ensure that generators do not receive abnormally high returns or that they do not engage in anti-competitive behavior by withholding capacity, the ISO-NE's methodology will attempt to balance capacity revenues with energy revenues, avoiding duplicate payments. However, this aspect of the LICAP market design may act as a disincentive for merchant generators to build new capacity, in part negating the ISO-NE's efforts.

↑back to top

The Demand Curve

LICAP is to be based on a demand curve established by the ISO-NE. The curve will be specific to each region defined by the ISO-NE, recognizing that some regions have structural capacity shortages. The five regions defined by the ISO-NE are NEMA/Boston, SWCT, the Rest of Connecticut, Maine, and Rest of Pool (including Vermont, Rhode Island, rest of Massachusetts, and New Hampshire). Given that each region has different capacity levels, the demand curve will provide for minimum capacity revenues, which will reflect the capacity supply characteristics of that region, offering higher prices for capacity-constrained areas such as NEMA and SWCT.

The proposed demand curve is illustrated in the chart.



ISO—Independent system operator. KW—Kilowatt.
Source: New England's Locational Installed Capacity Market, A Primer; The Aim Foundation, April 2005.

The X-axis of the demand curve depicts the amount of capacity in terms of a reserve margin, while the Y-axis depicts the revenue generators will receive, in terms of dollars per kilowatt-month. The demand curve ensures that below a minimum capacity level, generators will receive capacity payments that reflect double the cost to build new capacity, i.e. the cost to build a simple-cycle gas-fired peaking unit.

The demand curve starts out flat, indicating that any available capacity below a minimum reserve margin will receive the maximum in capacity revenues. The demand curve then has two slopes, the first of which is three times as steep as the second. As the minimum required reserve margin is exceeded, capacity revenues drop rapidly until the upper desired reserve margin limit is reached. Intuitively, the ISO-NE is attempting to give generators enough inventive to build new plants while maintaining a reserve margin of between 14% and 18% of projected demand.

↑back to top

Objections To LICAP

The proposed implementation of LICAP has caused significant concern and objections among many market participants, especially electric utilities, state regulators, and politicians. However, there has been little public reaction from merchant generators. The entities opposed to the implementation of LICAP raise the following concerns:

- Overall costs for electricity are projected to increase, in large part because the minimum capacity revenues recommended by the ISO-NE will be twice the cost of new generation (on a dollars-per-kilowatt of capacity basis). Opponents argue that such a figure is too high and possibly a lower multiple should be used because higher electricity prices may adversely affect local economies. The situation is exacerbated by the fact that the ISO-NE has established the minimum capacity prices through administrative

fiat, with an eye towards reliability, and with little regard to the costs involved.

- The minimum reserve level used in the creation of the demand curve is viewed as artificially high, forcing market participants to pay for capacity in excess of their needs and providing for reliability that is viewed as too costly without providing necessary tangible benefits. The ISO-NE is proposing the use of a minimum reserve margin that reflects reserve margins used in the days before the industry restructuring, as opposed to the industry standard of one-day outage in 10 years.
- The benefits anticipated from implementing LICAP might not materialize, as the ISO-NE's proposal allocates the capacity payments to all generators, without any guarantee that new entrants will arrive. As a result, existing incumbent generators will receive increased capacity payments for providing no incremental value or service. To make matters worse, it is not clear why generators would ever want to build enough capacity in any region to receive anything less than the maximum potential capacity revenues.
- LICAP does not address various barriers to entry that prevent the development of new capacity in areas that need it the most. As a result, it is possible that new capacity will continue to be built away from load, in places where development is relatively easy.

↑back to top

Credit Implications For The Participants

The potential implementation of LICAP appears to be credit neutral for investor-owned utilities that have divested their generation assets and now engage in electricity transmission and distribution. Since the utilities no longer generate electricity, their restructuring agreements provide for recovery of all power-related costs on a timely basis. Furthermore, since LICAP is to aid reliability, among other things, it is unlikely that any incremental capacity costs stemming from the implementation of LICAP will not be entirely recovered from ratepayers. If the capacity prices rise so significantly so that immediate recovery is politically unpalatable, it is possible that utilities may have to defer a portion of the costs and recover them at a later point in time. Under this scenario, a long recovery period could adversely affect credit quality. Yet another risk is that even under the currently supportive regulatory environment of states such as Massachusetts, the qualitative impact of the potential capacity cost increases can be significant. This is because the electric utilities are the customers' first contact with the industry, and many, if not most customers, are still unable to fully understand the impact of the electric industry restructuring. For such customers, an increase in capacity costs is viewed as an increase on their bill, irrespective of how the increase originates and who receives the actual revenues. As a result, such utilities face a public relations uphill battle, and must prepare their customers accordingly.

For utilities that remain integrated, the implementation of LICAP may also be a credit neutral event. This is because such utilities stand to earn LICAP revenues from their own generation, which may well offset the increased costs. The risk here is that increased LICAP costs not recovered through corresponding LICAP revenues may have to be recovered through a formal rate-filing process, presenting a measure of regulatory risk.

On the other hand, for incumbent merchant generators, the implementation of LICAP presents the potential for significant benefits, as the minimum capacity payments received will increase over the

existing ICAP levels. As a result, even if merchant generators do not rush to build new plants, their existing units will automatically be assured of higher revenues. There have been many and varying estimates as to the amounts merchant generators stand to receive, depending on where an equilibrium is decided, but one estimate is about $2 billion in incremental annual costs if the capacity reserve margin is maintained at the ISO-NE's target level of 20%*.

Ironically enough, the incremental annual cost more than doubles if the capacity reserve margin stays at ISO-NE's minimum reserve margin level¶.

↑back to top

Notes

*Source: "LICAP and its Lessons: A Kink in the Curve" by Bruce W. Radford, January 2005, Public Utilities Fortnightly.

¶Ibid.

↑back to top